McGraw-Hill Economics

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U.S. BUSINESS OUTLOOK, SHORT-TERM

For the first time in years, there will be no Scrooge-economist lurking around department stores at Christmas, mumbling "Bah humbug" to shoppers and managers in a holiday spirit.

Christmas 1983, that is, differs from recent Christmases past, which were celebrated during recessions or under the cloud of impending recessions. Right now, however, things are better: employment and personal incomes are rising; prices are not--at least not by much; and the unemployment rate is dropping. Not only do these goodies bode well for the holiday season, they point to continuing economic expansion in 1984.

In fact, after growing an estimated 3.4% in 1983, economic activity next year is forecast to spurt another 5.4%. At Christmas, the economic focus will naturally be on the consumer, but the central role in economic growth in 1984 will go to business. For to keep the economy strong next year, business will have to rebuild depleted inventories and modernize worn-out plant and equipment.

Already, the recovery has inspired business to make unusually strong investments in new capital equipment, and the conditions for further equipment investment seem to be in place. As for inventories, restocking is in the early stages, with much more expected to come.

However, despite the generally upbeat mood of 1984, the spirit of Scrooge will not be entirely absent. Most of the trouble next year will stem

from high interest rates. High rates have kept the dollar too strong for too long, thus undermining U.S. foreign trade. And more recently, rates have started to take a toll on housing.

Will Interest Rates Kill the Recovery?

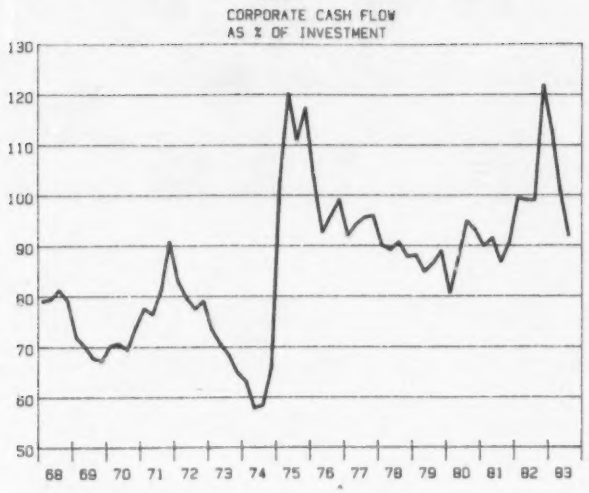
Why interest rates remain as high as they are (12% on high-quality corporate goods) even with inflation as low as it is (4%-5%) is explained by the U.S. government's monster budget deficits. Although the once mind-boggling notion of $200 billion deficits has now been around for more than a year, investors have apparently not become unboggled. Therefore, given the uncertainties those deficits create--crowding out? rapid money expansion? new taxes?--investors are tacking an extraordinary risk premium onto the yields they are demanding.

With the politicians unlikely to cut spending or to raise taxes significantly in an election year, the nation's ongoing financial ills will probably not receive any aid from Washington in 1984. Hence interest rates have little chance of declining very much.

At the same time, because corporate cash flow has picked up, business has not had to turn heavily to the credit markets for funds. As a result, despite the burst of capital spending that started in 1983's second quarter, credit demand by the corporate sector has not led to a major rise in interest rates.

It's true that as investment has risen, cash flow has covered less of the spending, as shown in Figure 1. But the figure also shows that cash flow relative to investment is at a fairly normal level. With cash flow projected to be robust, fears that sharp increases in business demand for funds will push rates skyward in the near term are probably not justified.

FIGURE 1



Another check on an interest rate rise is Federal Reserve Board policy. In subjective terms, the Fed probably wouldn't want to abort the recovery by letting rates go up. Objectively, the money supply is bouncing around near the lower limit of the Fed's targeted growth path. Thus there is room for the money supply to grow comfortably next year, without raising jitters on Wall Street about reigniting inflation.

The argument, then, is that interest rates could fall a bit in 1984, but that deficit uncertainties will keep the fall--if there is one--something less than dramatic. The corollary is that the economic expansion will make it through 1984, even though interest rates stay high. Witness, for example, the economic progress made in 1983 in the face of historically high interest rates.

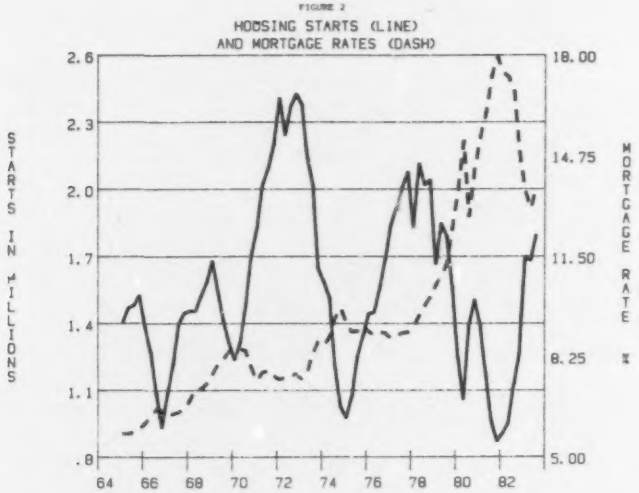
Which is not to say rates will leave the economy untarnished in 1984.

Housing: High Rates Start to Shake the Foundation

Probably the biggest victim of high interest rates in 1984 will be the housing industry, a major engine of recovery in 1983, but an engine that may now be sputtering.

The thing that got housing going--and that led to a 60% surge in starts in 1983--was the sharp drop in interest rates in the summer and fall of 1982. As Figure 2 illustrates, the relationship between mortgage rates and housing starts is a strong one.

FIGURE 2



Problem was, with federal deficit news getting more and more unsettling, interest rates got stuck on a high plateau by early 1983. Housing starts, nonetheless, pushed ahead. People who once stood face to face with 17% mortgage rates and backed down may have felt that 13% rates weren't so bad. That would have been especially true for people who had been saving in the meantime. Other buyers may have opted for adjustable rate mortgages; in some cases, developers may have offered subsidized rates.

Whatever the facts of each individual case, it all added up to an enthusiastic spree of home buying and building, with lots of people willing to bite the bullet of high monthly payments in order to own a house. To show how home buyers have become accustomed to higher rates, the last year in which so many houses got started was 1979 when mortgage rates averaged two percentage points lower than in 1983.

In recent months, however, housing enthusiasm has shown evidence of cooling, as the pool of people with down payment money and sufficiently high incomes has gotten shallower. For the sad fact is that mortgage rates of 12% to 13% close some two-thirds of American families out of the market for an average house. Hence it may be more than a statistical fluke that housing starts declined to 1.6 million units at an annual rate in October from 1.9 million in August.

The upshot is that housing will not help the economy in 1984 nearly as much as it did in 1983. Starts are forecast at 1.7 million in 1984, about the same as in 1983.

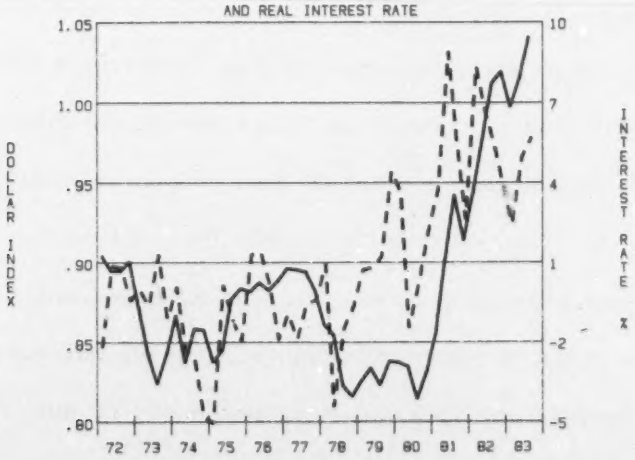
Global Recovery Offers a Glimmer of Hope to Exports

While housing weathered 1983's interest rates quite well, U.S. exports didn't. After adjusting for inflation, exports sank some 6% in 1983 after dropping 8% in 1982.

Worldwide recession obviously did much to erode foreign demand for U.S. goods, but the powerful U.S. dollar also helped do exports in. And the reason the dollar stayed strong: high interest rates that stimulated heavy demand for dollar-denominated financial investments. (See Figure 3 for the link between

FIGURE 3

U.S. DOLLAR (LINE)
AND REAL INTEREST RATE



NOTE: THE INTEREST RATE IS THE RATE ON 3-MONTH TREASURY BILLS MINUS INFLATION AS MEASURED BY THE GROSS IMPLICIT PRICE DEFLATOR FOR GROSS NATIONAL PRODUCT.

the dollar and interest rates.) What's more, continued high interest rates will keep the eagle flying.

Prospects for exports should be improving, however, as the rest of the world joins the U.S. in recovery. Growth in Europe, though, will likely be tepid. And due to immense debt burdens, key South American countries will restrict imports to conserve foreign exchange. Hence U.S. exports, while recovering, will not likely lead the economy in its second year of expansion.

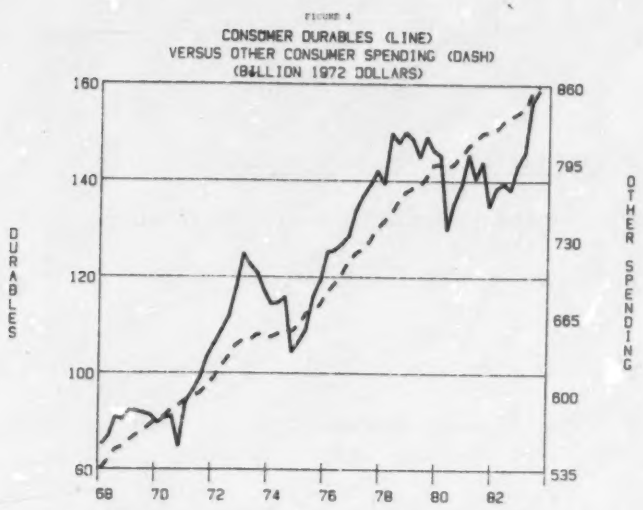
The Consumer Powers Down

So Scrooge may get some satisfaction next year from restraint in the housing and export markets. He may also get a little from consumer spending, where the growth rate is expected to slow down.

From the bottom of recession in the fourth quarter of 1982 to the fourth quarter of 1983, inflation-adjusted consumer spending rose an estimated 5%. In the next four quarters, it is expected to grow closer to 3%. The slowdown will develop as auto sales hit a cruising speed of about 10.5 million units (annual rate), up from an estimated 9.9 million in 1983's final quarter.

Reasons to think car sales will rise some more before topping out are the same reasons that explain increased sales in 1983: employment and incomes on the rise, gasoline prices under control, and lots of old clunkers needing replacement. Plus the fact that would-be car buyers have had trouble getting the models they want due to production snags at the auto factories. Hence a certain amount of demand has been bottled up, to be released in coming months.

Besides buying cars, consumers in 1984 should also be raising outlays on home furnishing--the natural follow-up to the housing boom of 1983. Consumer spending on nondurables and services will also grow, but more slowly, since these expenditures are less cyclical than purchases of durables, as shown in Figure 4.



The improvement in consumer conditions since the start of recovery is shown in Chart I. These numbers also point to continued gains in consumption

Chart I. Compared to Last Year, Consumers Remain In Good Shape

	1983 Third Quarter	1982 Third Quarter	1982 Annual
Personal Income (Billion $, SAAR)	2,763	2,591	2,579
Ratio of Debt Service to Disposable Income	0.1	0.1	0.1
Civilian Employment (Million)	101.6	99.6	99.5
Unemployment Rate (%)	9.4	10.0	9.7
Consumer Confidence Index	92	67	68

SAAR--Seasonally adjusted annual rate.

in 1984. With 1984 expected to witness a deceleration in auto sales, however, consumer spending next year will advance modestly through the year.

Business Spending: Basic Building Block in 1984

In contrast to consumer spending, business spending is forecast to help fire the expansion next year. The reasons:

- Rising sales and orders in 1983 have raised business confidence.
- With inflation down, firms will want to cut costs by employing the most modern, efficient equipment.
- Rising cash flow is enabling companies to finance capital equipment purchases with internal funds.
- The 1981 Tax Act, rendered ineffective by a year and a half of recession, is now providing strong incentives for capital spending.
- Inventories are too low relative to sales, and so must be built up.

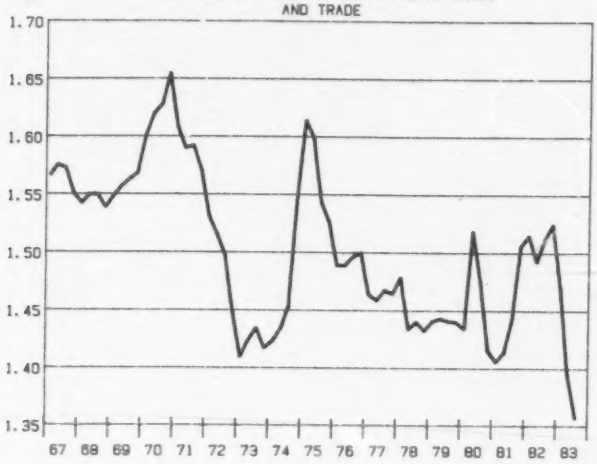
In short, there is every reason from both the demand and the supply side for business to spend. Thus after slashing inventories in 1982 and cutting them again in 1983, business is expected to stock up in 1984. This turnaround in inventories is expected to be so important, in fact, that it could account for nearly a fifth of the growth in real gross national product next year. Business investment in real plant and equipment, meanwhile, should account for close to a fifth.

The potential threat to inventory building is the high cost of financing. If high interest rates make companies willing to lose sales for lack of supplies, then inventory building and economic growth will be weaker than the 5.4% forecast for 1984. The bet here is that as the recovery continues to roll, more and more companies will want to participate fully by having product ready to go.

Due to computerized inventory control, low inflation (no need to buy before prices jump), fear of overstocking as in the 1980-81 recovery, and high financing costs, the ratio of inventories to sales may remain lower than normal. But, as shown in Figure 5, this ratio is so extremely low at present

that it has plenty of room to rise before reaching the normal zone.

FIGURE 5
INVENTORY-SALES RATIO FOR MANUFACTURING AND TRADE

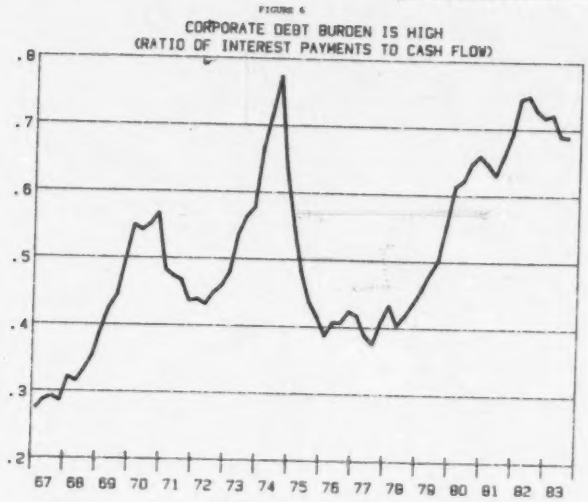


The threat to investment in new plant and equipment also includes current interest rates, but perhaps more important it includes past interest rates now reflected in high interest payments. Hence even though cash flow is strengthening, a significant portion of nonfinancial corporations' liquid resources must go to pay off old debt.

True, companies have been whittling down their debt burden for more than a year now. But as shown in Figure 6, that burden--measured by the ratio of interest payments to cash flow--is still far higher than in 1976 when the last sustained capital spending boom started. Other balance sheet measures--such as the ratio of short-term to total liabilities--also signal further need to restructure balance sheets.

The upshot is that although forces working for sustained capital spending growth are strong and will propel real spending forward by some 8% next year, financial constraints will help prevent growth from reaching the 10%-12% range that could otherwise be reached. That financial obstacles have not prevented the very sharp capital investment advance since 1983's second

FIGURE 6



quarter testifies to business' large capital replacement and modernization needs, needs intensified by surging economic activity and aggravated by four years of no real investment growth. (From 1979 to 1983, inflation-adjusted capital spending fell about half a percent per year on average.)

The big worry with capital investment, as with the economy as a whole, is 1985. If corporate balance sheets are not better aligned by the end of 1984, capital spending could get crimped, especially as cash flow growth decelerates as the economy passes its period of peak growth.

Summary

Business spending on inventories and capital goods will be the prime force pushing the economy forward in 1984, as shown in Chart II. Consumer spending will also help keep the recovery intact. But as auto sales top out, overall consumer spending will be less of a power in 1984 than in 1983.

Meanwhile, high interest rates will prevent housing starts from climbing much from their 1983 level. Residential construction will remain strong, though, partly due to the buildup in 1983 starts. But it will not even

approach its rate of growth in the past year. High interest rates will also keep the dollar strong, which means continuing weakness in the U.S. trade balance.

At the same time, high rates are not expected to undermine the recovery altogether. The high federal deficit continues to raise fears over a credit market collision; but because corporate cash flow is likely to be robust, much investment should be covered by internal funds. Ergo, no interest rate crisis in 1984.

Chart II. Business Spending on Inventories & Capital Will Lead 1984

	-------Real % Change-------	
	1982:4 to 1983:4	1983:4 to 1984:4
Gross National Product	6.3%	4.4%
Consumer Spending	5.2	3.3
Residential Construction	38.0	7.1
Business Fixed Investment	8.2	7.3
Change in Inventories (Billion 1972 $)*	11	16
Net Exports (Billion 1972 $)*	9	7

*Figures are for single quarters, 1983:4 and 1984:4.

NATIONAL PRODUCT ACCOUNTS AND KEY ECONOMIC INDICATORS

(Billions of Dollars, SAAR)

	-Actual-	----------Forecast----------					--------Annual--------		
	1983	1983	1984						
National Product Accounts	3Q	4Q	1Q	2Q	3Q	4Q	1982	1983	1984
Gross National Product	3360.3	3445	3535	3617	3698	3776	3073.0	3312.1	3656.3
Consumer Spending	2182.9	2232	2282	2327	2373	2415	1991.9	2158.6	2349.2
Durables	284.5	300	308	315	324	328	244.5	280.1	318.7
Nondurables	814.8	825	841	855	868	881	761.0	804.2	861.2
Services	1083.6	1107	1133	1158	1182	1206	986.4	1074.4	1169.4
Fixed Investment	485.9	496	510	523	541	556	435.8	470.9	532.5
Nonresidential	349.6	360	370	380	391	401	348.3	344.6	385.6
Structures	130.1	133	137	141	145	149	141.9	130.9	142.9
Producers Durable Equipment	219.6	227	234	240	246	252	206.4	213.7	242.6
Residential	136.3	136	140	143	150	155	87.5	126.3	146.9
Inventory Change	8.7	26	25	31	36	40	-24.6	-4.7	33.1
Federal Government	278.9	276	294	303	311	322	258.7	275.5	307.8
Defense	201.9	209	216	223	229	238	179.4	201.1	226.4
Nondefense	77.0	68	79	81	83	84	79.3	74.5	81.5
State & Local Government	420.6	428	437	447	456	465	390.5	415.7	451.1
Net Exports	-20.2	-18	-18	-19	-23	-26	17.4	-7.4	-21.4
Real GNP (1972 Dollars)	1553.6	1574	1593	1611	1629	1644	1485.4	1535.8	1619.0
(% change at annual rate)	7.7	5.4	4.9	4.6	4.5	3.7	-1.9	3.4	5.4
Implicit Price Deflator	2.163	2.188	2.219	2.246	2.271	2.297	2.069	2.156	2.258
(% change at annual rate)	3.2	4.7	5.8	5.0	4.5	4.7	6.0	4.2	4.7
Key Economic Indicators & Assumptions									
Unemployment Rate (%)	9.4	8.8	8.5	8.3	8.1	7.9	9.7	9.7	8.2
Housing Starts (thousand units)	1793	1621	1662	1724	1812	1739	1059	1698	1734
Auto Sales (million units)	9.3	9.9	10.1	10.3	10.6	10.6	8.0	9.2	10.4
Industrial Production (Index, 1967 = 100)	151.7	156.2	159.6	161.5	163.5	165.0	138.6	147.7	162.4
Consumer Price Index (% change at annual rate)	4.7	5.0	5.1	5.0	4.7	4.4	6.2	3.3	4.9
90-Day Treasury Bill Rate (%)	9.1	8.7	8.5	8.2	8.0	8.2	10.6	8.6	8.2
Corporate Bond Yield (%)	12.3	12.5	12.4	12.2	12.0	11.7	13.8	12.1	12.1
Disposable Personal Income ($ Billions, SAAR)	2763	2837	2901	2955	3012	3072	2579	2743	2985

SAAR-Seasonally Adjusted Annual Rate

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The hot U.S. economy has cooled off.

In the final quarter of 1983, economic activity grew at a 4.5% annual rate, well below the pace of 1983's second and third quarters. The slowdown in growth was, of course, expected. But now that it's here, it concentrates the mind on America's economic problems--and possibilities--in 1984.

Most glaring of the problems pointed up by the fourth quarter is the U.S. international trade position. Net exports (exports minus imports) plunged at a $33 billion annual rate, lopping some two percentage points off economic growth in the October-December period. The cause of the trade tumble: strong growth of the U.S. economy relative to other countries plus a super-strong U.S. dollar. These causes won't disappear in the short run, meaning further export/import problems in 1984.

The prime reason the U.S. dollar is so strong is the high level of U.S. interest rates, which leads to domestic problems as well. Perhaps most apparent of these problems right now is housing: Starts have slipped a bit recently, and they don't promise to perk up much from now on.

At the same time that high interest rates have shoved net exports to the floor and tripped up housing, however, they have not prevented business from sharply hiking capital investment. And with corporate cash flow rising, more investment is expected this year.

Nor have high rates prevented consumers from spending a bundle on new cars, household furnishings, and other goods and services. And with employment and personal incomes rising, more consumption is also in the cards in 1984.

Since consumption is the biggest chunk of gross national product (GNP), and since business investment is also an important chunk, the economy will therefore continue to expand this year. But those high interest rates and low net exports raise concerns about the ongoing strength of business activity beyond 1984.

How Are We Doing?

Although it arrived two years behind schedule, the Reagan economic boomlet has been welcomed with jubilation. Look how strong the economy has been, many say; see how well Reaganomics works; capital investment has surged, autos and housing have surged, the stock market has surged; prospects for the economy are bright.

All of which is true. But from a somewhat different perspective, last year's economy--while undoubtedly a success story--does not necessarily point to more chapters with happy endings. That perspective is one with 1979 as a base year, as shown in Chart I.

By almost every measure, the U.S. economy--despite the 1983 recovery--has not regained the level of production attained four years earlier. Granted, the measures in Chart I may insufficiently account for structural shifts in the U.S. economy--shifts away from heavy industry and toward services and high-tech. For example, even as auto sales and industrial production declined from 1979 to 1983, GNP and total civilian employment rose.

Chart I. Economy Still Sags In Some Ways

	1979	1983	% Change, 1979 to 1983
Housing Starts (million units)	1.745	1.715	-1.7%
Domestic Auto Sales (million units)	8.2	6.8	-17.1
Industrial Production (index, 1967=100)	152.5	147.7	-3.1
Capital Spending (billion 1972 $)	169.9	168.0	-1.1
Exports (billion 1972 $)	146.2	138.9	-5.0
Employment (millions)	99.5	100.8	+1.3
Corporate After-Tax Profits (billion $)	165.1	130.2	-21.1
GNP (billion 1972 $)	1479.4	1534.8	+3.7

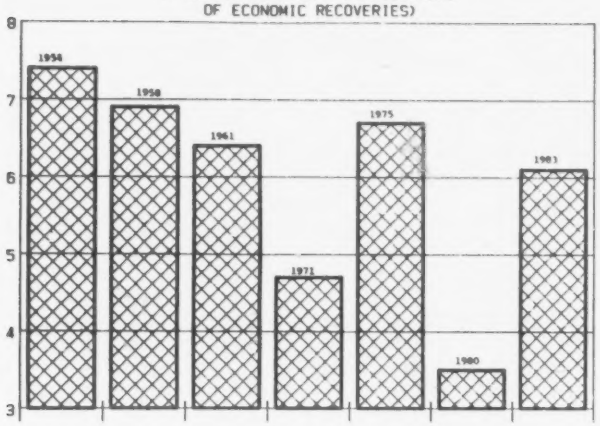
The big boost to GNP during the period came from consumer expenditures for services such as health care and entertainment. Government spending on the military also boosted GNP significantly from 1979 to 1983.

Nonetheless, continuing strength in the economy can't depend on people going to doctors and ball games, and on the government making missiles. Cyclical and interest-rate-sensitive sectors such as housing, autos, capital spending, and exports--which together account for a quarter of GNP--must get beyond their improved 1983 levels if the economy is to enjoy sustained growth.

Thus the issue now is not how wonderful the 1983 recovery was. (Even that wasn't quite as good as its press; in fact, it was below average for a recovery, as shown in Figure 1.) The issue now is whether the Reagan economic locomotive, weighted down by heavy deficits and burdensome interest rates, can keep chugging through 1984 and beyond.

FIGURE I

THE 1983 RECOVERY LAGGED A BIT
(% GROWTH IN FIRST FOUR QUARTERS
OF ECONOMIC RECOVERIES)

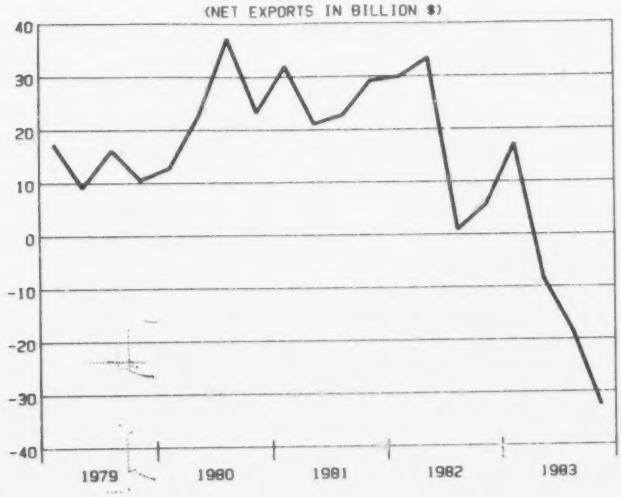


Exports Keep Sinking

One of the wobbliest wheels on the locomotive is exports, which are fighting against both the soaring U.S. dollar and non-soaring foreign economies. The world economy has improved enough to stimulate U.S. exports, but other countries' demand for U.S. goods is not nearly strong enough to allow improvement in the U.S. trade balance, pictured in Figure II.

FIGURE II

U.S. TRADE BALANCE PLUNGES
(NET EXPORTS IN BILLION $)



The trade balance in Figure II is for goods and services. In large part due to income from foreign investments, the U.S. runs a hefty surplus in services. But on merchandise account, the U.S. dives deep into the red. Petroleum, of course, is a big source of red ink. But autos and consumer goods also play major roles in running up the deficit.

Now deficits in some product areas are not bad in and of themselves. In principle, pluses in some accounts should offset minuses in others. If the minuses proliferate too much, a deficit country's currency should depreciate, making its exports more competitive. Thus the deficit should be self-correcting.

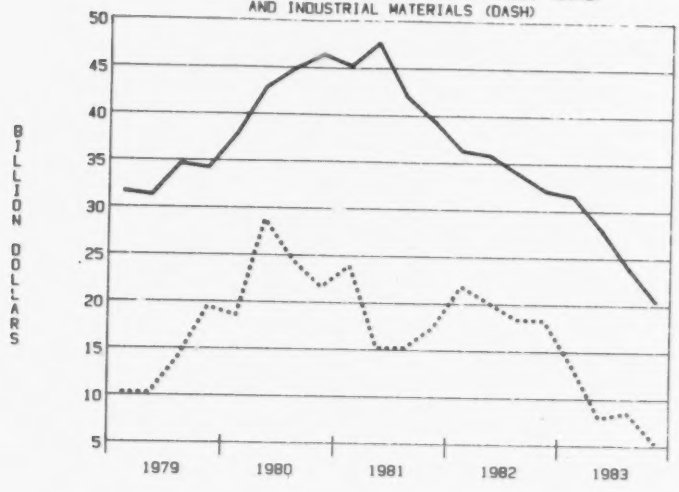
At present, however, you can throw out the textbook: The U.S. trade balance has been deteriorating badly, yet the dollar has been strengthening, and that has spelled hard times for U.S. manufacturers.

Since trade deficits are not pushing the dollar down, it is clear that a more powerful force is pushing the dollar up. That force is high interest rates, which implies that U.S. manufacturers trying to export or trying to compete against imports face more hard times. For big budget deficits are expected to keep interest rates--hence the dollar--high.

Of course not all sectors of U.S. merchandise trade are in deficit. Traditionally, for example, the U.S. has enjoyed strong trade surpluses in industrial materials like chemicals as well as in capital goods. Yet the strong dollar has taken a heavy toll on these powerhouses, too, as shown in Figure III.

FIGURE III

TRADE SURPLUS DWINDLES IN CAPITAL GOODS (LINE) AND INDUSTRIAL MATERIALS (DASH)



If such trends continue and the dollar still refuses to drop significantly, then further erosion of U.S. sales (hence employment and incomes) could cause problems for the overall economy, perhaps before the year is over.

Capital Spending Cranks Up, But...

While U.S. capital goods producers have been struggling on the choppy seas of international trade, they have enjoyed smoother sailing at home. After taking out inflation, capital spending in the U.S. surged 11.5% from the fourth quarter of 1982 to the fourth quarter of 1983.

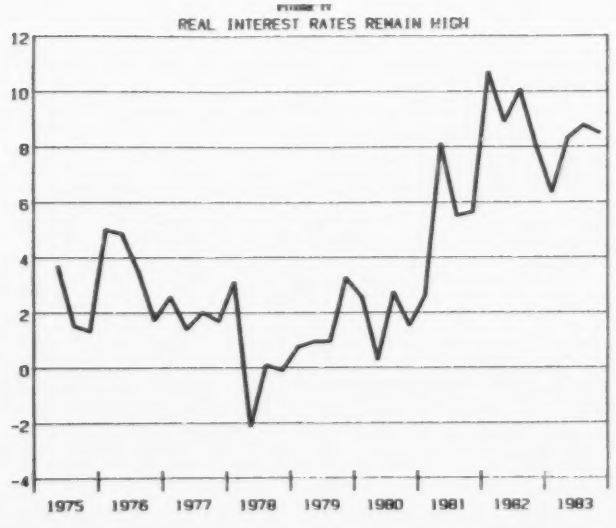
Within capital spending, however, all of the action came in equipment, up more than 18%. Construction, meanwhile, tumbled 2.7% from the end of 1982 to the end of 1983.

In 1984, as companies strive to cut costs by modernizing plants and offices, capital investment in equipment should enjoy another good year. Investment in structures should also grow. But construction will be confronted by two general constraints--high interest rates and economic uncertainty. In addition, there is one specific problem--an overbuilt office market.

High interest rates of course hurt many sectors of the economy. But most particularly they hurt big-ticket outlays like buildings geared to long-term payback periods. The bigger the interest payments on a project, the longer the payback period, all other things being equal. In fact, if rates are too high, the project may never pay off; hence it will never get started.

Uncertainty plays a similar, if less quantitative, role. For example, if companies think there is a good chance of recession hitting in the next couple of years, it means revenues generated by a long-term project could be weak. Hence the estimated payback period could turn out to be too long to justify investing.

While uncertainty is not observable, there are a few ways of thinking about it. One is that since 1979 the economy has suffered two recessions, leaving it saddled with the biggest government budget deficits in history. And that's cause for worry. Another gauge is that, compared to history, market interest rates are way above the inflation rate, as pictured in Figure IV. Financial investors, that is, think there is a lot of risk in lending money these days; hence they are demanding a large premium.

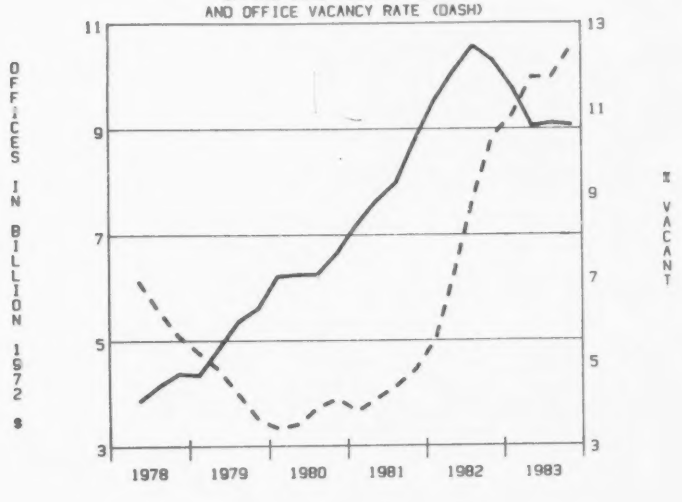


High interest rates and uncertainty will affect all types of business construction this year. But the office market may be in for more trouble than other markets.

Some five years ago, when the white collar work force was growing rapidly and office space was at a premium, office buildings started to rise at a phenomenal rate. By the end of 1983, however, huge amounts of office space coming on the market had boosted the office vacancy rate to 12.4% versus only 5.5% as recently as early 1982.

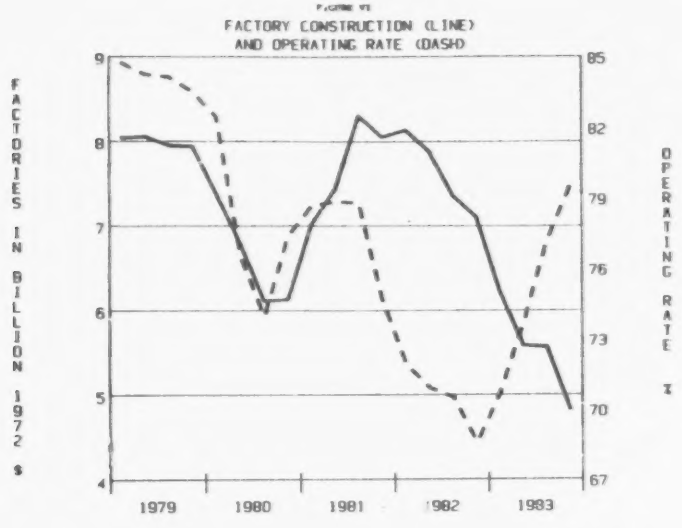
Even though tax shelter investment may be buoying spending on office buildings at present, the high and rising vacancy rate points to declining office construction in 1984. In fact, as Figure V shows, that decline has already set in.

FIGURE V
OFFICE CONSTRUCTION (LINE)
AND OFFICE VACANCY RATE (DASH)



By contrast, factory construction should start to pick up soon in response to rising factory capacity utilization, as shown in Figure VI. But because factory operating rates had fallen to such depressed levels in recent

years, and because interest rates were so high, factory construction plummeted. Hence even a good pickup in 1984 will leave industrial construction at a relatively low level.



The brightest spot in business construction this year will be in stores and warehouses, which follow behind residential construction by up to a year. Thus, due to the housing boom in 1983, building of retail stores, restaurants, and their warehouses will bloom in 1984.

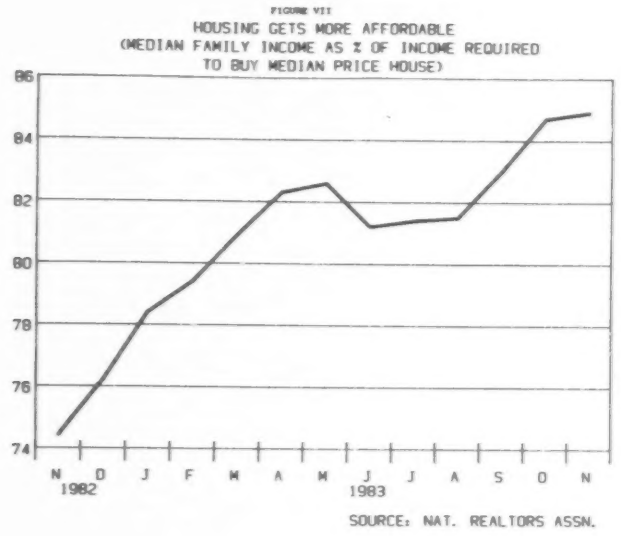
Housing Heads For Cover

The burst of store construction may peter out by the end of 1984, however, because housing starts in 1984 will likely flatten out. Once again, the key culprit in the housing slowdown will be high interest rates.

True enough, housing starts zoomed 62% last year even in the face of 13% mortgages. Yet some of that demand was driven by people who had been waiting and saving to buy a house for a couple of years. That pool is now smaller.

And new people entering the housing market do not have the financial resources of the waiters and savers. Thus high interest rates will matter more this year than they did last year.

At the same time, high rates will probably not sink the housing market. After all, more and more people are finding jobs and earning more money compared to a year ago. Add that to the fact that housing prices stopped surging during the recession, and it means houses are becoming more affordable, as shown in Figure VII.



Hence the housing market is expected to stumble along at about the same level it reached in 1983.

Consumers Will Keep Spending

For similar reasons--jobs and incomes--the consumer comeback of 1984 is forecast to keep on track. There is, however, one worry here: high interest rates, hence large interest payments that consumers must make on borrowed money.

As a share of disposable income, those interest payments have climbed sharply in recent quarters, as shown in Figure VIII. The figure also shows consumer spending on durable goods, measured in billions of constant 1972 dollars. The danger suggested by the figure is that, at some point, the debt burden gets so high that people draw back from the marketplace and instead use their money to reduce debt payments.

Another "danger" is that consumers may stop spending so much of their income--i.e., they may start to save more. In the recent past, people have cut the share of disposable incomes saved to some 5%, far below the average of 7% in the 1970s. If people return to their previous savings habits, consumer spending could hit the skids.

Given strong growth in employment and incomes, however, it's not likely that consumers will actually cut spending. The more likely outcome is that consumer spending will slow down, yet still provide strength to the economy in 1984.

At some point, however, high financing costs will put a damper on purchases of big-ticket items. But due to rising income and last year's housing boom, sales of cars, furniture, and appliances are expected to grow solidly this year.

Unfortunately, interest rates will probably still be high in 1985, and by then will start to push down the growth rate of durable goods spending. The reason to expect continued high rates is the same reason that rates have been so high in recent years.

That is, mammoth government deficits will remain mammoth, especially in an election year when no politician wants to raise voters' taxes or cut their favorite spending programs. This lack of political will is also embodied in the President's budget, which points to $200 billion budget deficits for years to come. So much for growing our way out of the deficit.

Summary

1983 was a very good year for the economy. It marked the first year of a long-awaited recovery. 1984 should mark the second year. In the forefront of the 1984 economy should be business investment.

Restraining the economy in 1984 will be high interest rates, kept high by continued high budget deficits. High interest rates will in turn keep the dollar strong, so the trade balance will continue to swim in red ink.

Because the economy entered 1984 so briskly, however, rising incomes and profits should spur enough business and consumer spending to lift GNP some 5% in 1984, after inflation. But with little prospects in sight for tackling the budget deficits, high interest rates could put the economy in jeopardy in 1985.

NATIONAL PRODUCT ACCOUNTS AND KEY ECONOMIC INDICATORS
(Billions of Dollars, SAAR)

National Product Accounts	-Actual- 1983 4Q	Forecast 1984 1Q	1984 2Q	1984 3Q	1984 4Q	1985 1Q	Annual 1982	Annual 1983	Annual 1984
Gross National Product	3,432.0	3,523	3,592	3,669	3,750	3,816	3,073.0	3,309.4	3,633.6
Consumer Spending	2,233.1	2,271	2,316	2,361	2,404	2,448	1,991.9	2,158.6	2,338.1
Durables	295.2	300	309	318	325	330	244.5	278.6	313.1
Nondurables	825.9	838	851	864	877	890	761.0	804.3	857.3
Services	1,112.0	1,133	1,156	1,179	1,203	1,228	986.4	1,075.7	1,167.8
Fixed Investment	508.3	520	532	546	558	568	435.8	474.6	539.0
Nonresidential	371.2	378	387	397	407	418	348.3	347.7	392.1
Structures	134.5	137	141	145	149	153	141.9	131.4	142.9
Producers Durable Equipment	236.8	241	246	252	258	255	206.4	216.3	249.3
Residential	137.1	142	145	149	151	150	87.5	126.9	146.9
Inventory Change	17.7	36	24	28	37	37	-24.6	-6.9	31.1
Federal Government	275.6	285	302	309	320	328	258.7	275.2	304.1
Defense	206.2	214	221	227	236	242	179.4	200.3	224.6
Nondefense	69.4	71	81	82	84	86	79.3	74.9	79.4
State & Local Government	426.1	434	443	453	462	472	390.5	415.0	448.1
Net Exports	-32.6	-26	-30	-32	-36	-41	17.4	-10.6	-30.9
Real GNP (1972 Dollars)	1,570.5	1,592	1,607	1,625	1,641	1,652	1,485.4	1,534.8	1,616.2
(% change at annual rate)	4.5	5.6	3.9	4.3	4.0	2.8	-1.9	3.3	5.3
Implicit Price Deflator	2.185	2.213	2.235	2.259	2.285	2.310	2.069	2.156	2.248
(% change at annual rate)	3.9	5.2	4.0	4.4	4.7	4.4	6.0	4.2	4.3
Key Economic Indicators & Assumptions									
Unemployment Rate (%)	8.5	8.1	7.9	7.8	7.6	7.5	9.7	9.6	7.8
Housing Starts (thousand units)	1,692	1,771	1,803	1,818	1,738	1,671	1,059	1,715	1,783
Auto Sales (million units)	9.9	9.8	10.1	10.4	10.5	10.6	8.0	9.2	10.2
Industrial Production (Index, 1967 = 100)	156.0	159.1	161.1	162.9	165.0	166.6	138.6	147.7	162.0
Consumer Price Index (% change at annual rate)	4.8	4.1	4.4	4.5	4.5	4.9	6.2	3.2	4.5
90-Day Treasury Bill Rate (%)	8.8	8.8	8.7	8.4	8.7	9.1	10.6	8.6	8.6
Corporate Bond Yield (%)	12.4	12.4	12.2	12.0	12.0	12.3	13.8	12.0	12.2
Personal Income ($ Billions, SAAR)	2,834	2,894	2,941	2,997	3,057	3,117	2,579	2,742	2,972

SAAR-Seasonally Adjusted Annual Rate

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McGraw-Hill Economics

1221 Avenue of the Americas, 37th Floor
New York, New York 10020

May, 1984

Business Outlook, Short-Term

President Reagan promised us an economic rose garden when he took office three years ago. At first, we got only thorns.

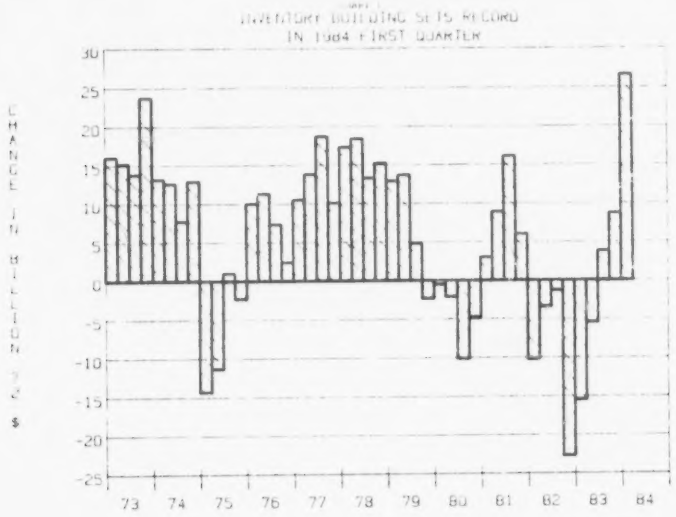
More recently, of course, everything has in fact been coming up roses. From late 1982 to late 1983, the economy flowered nicely, with growth surging in the middle of 1983. Growth slowed to a comfortable 5% annual rate by the final quarter, presumably setting the stage for modest yet sustainable advance in 1984. But then, despite rising interest rates, the economy in 1984's first quarter burst forth again, this time at an 8.3% annual rate.

Eight point three is a big number. Yet not too much hooplah should be made over it because of the way it was attained--by a massive inventory buildup. Outside of inventories, in fact, demand was quite modest. In other words, the economic rose garden ran riot in the first quarter due to some special fast-action but short-lived fertilizer, which does not get rid of the thorns.

Inventories in the Driver's Seat

Inventories probably rank as the number one forecasting headache for economists. Stocks can swing sharply from one quarter to another, and thus can play the major role in determining overall economic growth in any single three-month period. That was the case in 1984's first quarter when the record

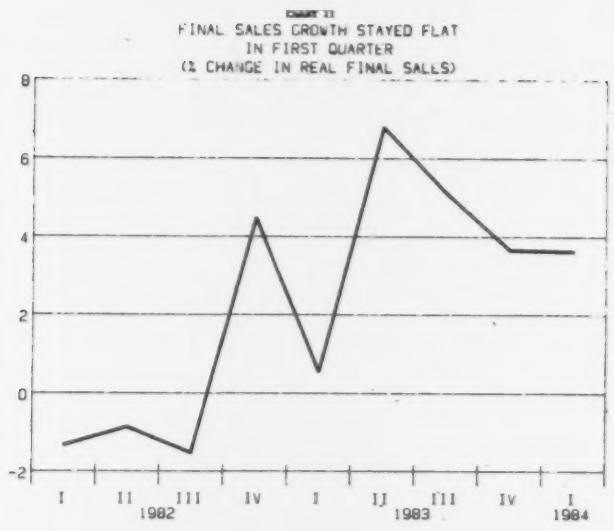
inventory surge (see Chart I) tacked 4.6 percentage points onto the overall growth rate of 8.3%. (Much of the surge, moreover, occurred in farm inventories, partly due to technical accounting procedures.)



Now inventories sometimes surge because producers, wholesalers, and retailers can't move their goods; and sometimes inventories surge because businesses--confident about sales prospects--want to make sure they have plenty of goods on hand to keep all customers happy. Sometimes, however, it's hard to disentangle intentional from unintentional inventory building.

One clue to the mystery is final sales, which is end-market demand for goods and services, or total output minus output going to restock inventories. Growth of final sales after inflation, shown in Chart II, flattened in the first quarter. Which implies that business, with plans based on the super-hot middle months of 1983, could have overestimated sales in early 1984. The result: Lots of product that went onto the shelves just sat there.

The corollary: Retailers and wholesalers will now slow their order rate, production will slow down, and inventory building will slow. As a



result, economic growth will slow down. Hence the forecast calls for the economic growth rate in coming quarters to fall by more than a half from the rapid first-quarter pace.

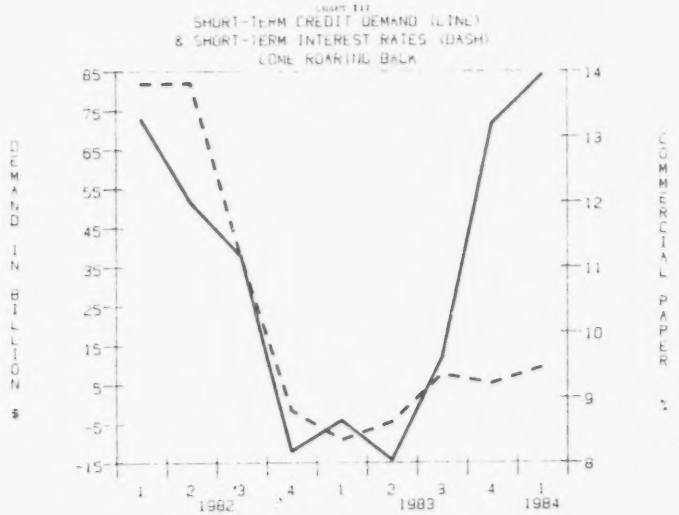
Wall Street Would Welcome Weakening

If the economy does take a breather from now on, the biggest relief may be felt on Wall Street. It's not, of course, that investors oppose growth per se. It's just that too much growth points to big credit demands, which push interest rates up, which reinforces fears of an economy run amok. Those fears, in the form of business demand for bank loans and commercial paper along with commercial paper rates, are pictured in Chart III.

Not pictured is the federal demand for funds, which of course is immense and will remain immense. And because of the federal deficit's immensity, the interest rate outlook remains grim. For if the Federal Reserve tries to finance the deficit, growth in the money supply will signal that inflation will rise, a reason for investors to demand higher interest rates. If the Fed does not monetize the debt, strong Treasury demand for credit will

squeeze the nation's supply of savings.

Yet at least in the near term, financial market pressures may abate a bit. For one thing, recent demand for credit was pushed up by large corporate mergers. Mergers of that size will probably not be repeated soon, so less money will be borrowed for buying other companies.



Another thing is that in order to amass inventories in the first quarter, companies had to borrow heavily. If, as expected, inventory building eases, demand for credit will also ease. A third thing is that state and local coffers are now filled to overflowing, thanks to recovery-spurred increases in tax collections.

Interest rates, therefore, are not forecast to go up much more in the near future. At the same time, they probably won't go down much, either, primarily because of federal government demand for funds. With interest rates in something of a holding pattern, then, sales of big-ticket consumer items such as autos and appliances will probably not grow as rapidly as in recent quarters. And housing starts will likely settle down in the 1.7 million range (anual rate) after exploding in January and February to the 2 million range

and then plunging in March to less than 1.7 million.

The Consumer Will Carry On

If interest rates behave as just described--nothing too dramatic on either the up or down side--then the economy should lope along at an acceptable pace in the coming months. Offsetting the inventory flip-flop that will work against growth will be more basic forces--such as those shown in Table I--that have been improving fairly steadily. These steadier forces point to further, though slower, gains for the economy.

Table I. Despite Weak Spots, the Economy is Still OK

	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	1983 Annual
Housing Starts (Million, SAAR)	1.67	1.73	1.69	1.98	2.23	1.64	1.70
Employment (Millions)	103.7	104.3	104.6	104.9	105.6	105.8	102.5
Personal Income (Billion $, SAAR)	2813	2834	2860	2907	2927	2941	2742
Retail Sales (Billion $, SA)	100.9	101.9	102.4	106.6	105.7	103.4	97.8*
Unemployment Rate (%)	8.8	8.4	8.2	8.0	7.8	7.8	9.6
Consumer Confidence (Index, 1967=100)	89	91	94	100	97	101	88
Manufacturers' New Orders (Billion $)	183	187	188	189	191	196	174*

SA--Seasonally adjusted
SAAR--Seasonally adjusted annual rate
*Monthly average for 1983

The further gains are foretold by the higher level of economic activity in recent months compared to several months ago; the slowdown in such gains are suggested by the weak spots showing up in February and March--especially in housing and retail sales.

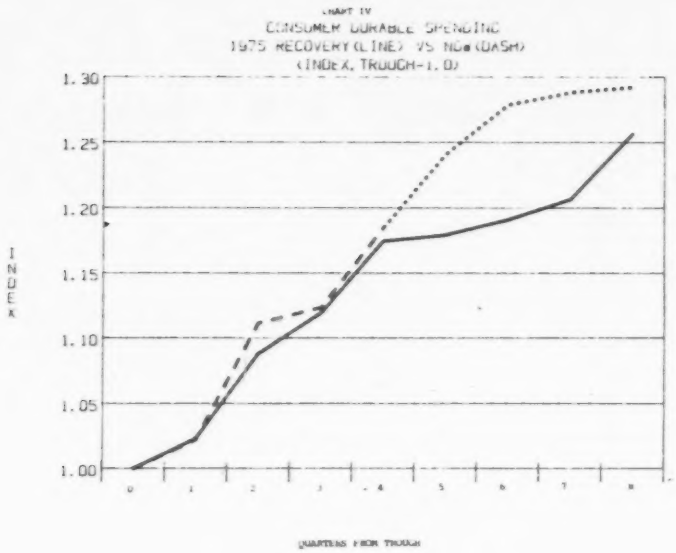
These weak spots, though, are not considered cause for alarm. Yes, retail sales have dipped, but at least part of the blame can be placed on exceptionally harsh weather. Meanwhile, with rising employment (shrinking unemployment) and rising incomes spurring confidence, the consumer is not yet ready to run for cover.

Rising income is also making houses affordable for a lot of American families who had earlier been closed out of the market. Many people are also being lured to housing by adjustable rate mortgages, which feature interest rates well below market for limited time periods. Thus the March plunge in housing starts is not considered the prelude to a bust.

Which is not to say that everything is peachy keen, either. For example, with rising interest rates pushing up monthly car and house payments, household debt burden (debt service as a percent of income) is on the rise; at some point that could crimp consumption. And when interest rates rise on those adjustable rate mortgages, people faced with higher monthly payments may cut back spending in other areas.

People may also decide to save more, as they have in recent months. That, too, would cut into consumption growth.

All in all, however, the consumer is expected to do his/her part to keep the economic expansion in train. For durables in particular, shown in Chart IV, sales are still advancing sharply, though they are forecast to flatten later this year. Nonetheless, the durables recovery in the current business cycle is expected to top that of the 1975-76 recovery, as is also shown in Chart IV.

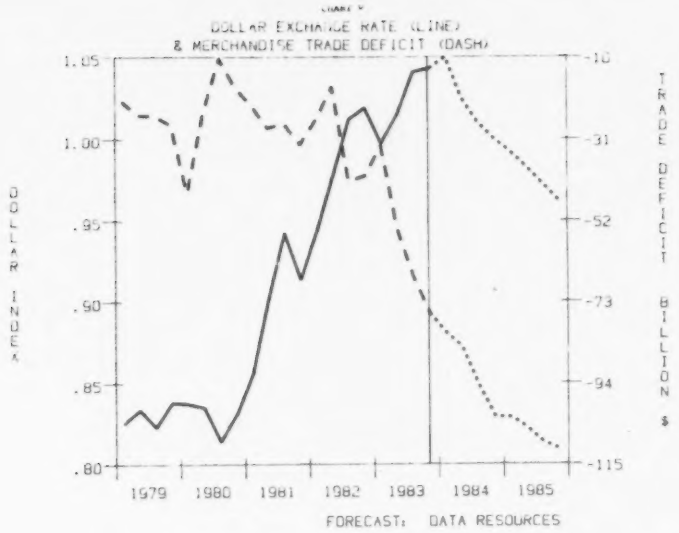


Troubled Waters: Foreign Trade & Investment

Table I above provides grounds for both economic optimism and concern. But Table I bears mostly on the domestic economy and does not point up some troubling matters on the international scene. Of most direct importance is continuing deterioration in the U.S. foreign trade balance. The other issue, not a current but a potential problem, is heavy foreign funding of the U.S. federal deficit. Both issues are tied to the strong U.S. dollar.

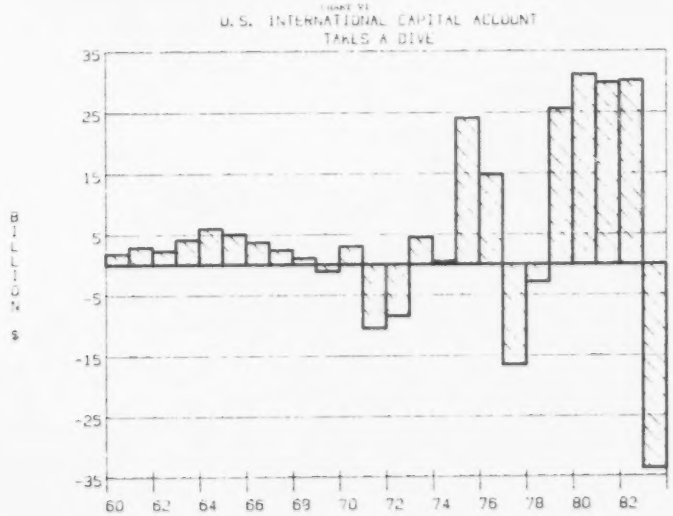
The impact of the dollar on merchandise trade is especially tremendous, as suggested by Chart V. This year the deficit in goods will almost surely hit a record, somewhere on the order of $100 billion. As the rest of the world gets stronger, U.S. trade will improve, but to what extent is unclear. Which means that U.S. firms who export and who compete against imports still have a ways to go before getting in on the economic expansion.

As the U.S. trade account continues to gape, an ever increasing number of dollars will be spewed into international markets, pushing the value of the



dollar down--an event beneficial to U.S. trade. Offsetting this effect, however, will be high interest rates, which will continue to make the dollar a top draw for foreigners seeking both a safe investment and a good return.

To get an idea of the recent foreign interest in U.S. investments (like Treasury securities), see Chart VI. Typically, the U.S. is a large net provider of funds to the rest of the world. But as the chart shows, the situation has turned around dramatically.



This development is good for the U.S. in that foreign capital is helping to finance the huge federal credit needs, thus relieving some pressure on interest rates. But at the same time, this large, highly mobile mass of foreign money also causes jitters.

For what if foreigners start to feel, as most analysts do, that the dollar is overvalued and is bound to fall? In that case, they might pull their investments out of dollars and put them into currencies expected to appreciate. If enough foreign capital fled the U.S., only domestic savings would be left to plug the federal budget gap and to finance business and consumer demand for credit as well. A possible result: Interest rates could spurt. Another possible result: The dollar could plunge. Thus, ironically, while a precipitous decline in the dollar would help the U.S. economy, a decline of this sort could reignite inflation, lead to Federal Reserve tightening, and generally cause economic disruption.

This may well be a worst-case scenario for the effects of foreign trade and investment on the U.S. economy. But it is one that should be kept in mind.

And even without a plunge in the dollar and a sharp rise in interest rates, rates do in fact remain the major problem in the economic outlook. They are the reason why the economy must inevitably slow, and why some forecasters are already seeing at least one quarter of economic decline in 1985.

Summary

The economic expansion showed renewed vigor in 1984's first quarter--a sort of "double-blip" recovery. But after taking out inventory investment, growth in the first quarter was quite modest.

Inventory accumulation is, of course, a key element in any recovery. After running inventories down during recession, firms have to build them up again when sales pick up. So growth due to restocking is still growth.

But with consumer spending starting to die down a bit, some of the restocking in the January-March period may have been unintended. Hence some companies may be stuck with more inventory than they bargained for, which means that enthusiasm for inventory accumulation will abate. Order rates, then production, will therefore slow, bringing economic growth in the next few quarters down substantially from the first quarter.

Which is not to say the expansion is over. Buoyed by strong employment and income gains, consumers are confident, and thus will continue to help the expansion along. Housing, while running afoul of high and rising mortgage rates, will hang in as bigger incomes make new homes more affordable and as banks continue to offer adjustable rate mortgages.

Nonetheless, interest rates do remain a tremendous problem for the economy. What's more, there is no near-term hope the problem will get better. Strong credit demand from the private sector coupled with strong deficit-driven demand from government has been pushing rates up. And the pressure will continue. The rate situation could be exacerbated, moreover, if the large amount of foreign capital flowing to the U.S. starts flowing out, placing the burden of deficit-financing fully on domestic savings.

At some point, the bite of high interest rates could catch up to their bark; at least they should bite more than they have thus far in the expansion. So for this reason, too, economic growth is forecast to slow--to about 4% (annual rate) in the next couple of quarters. By 1985, growth is expected to slow still further. Yet at least for the moment, no recession is in sight through the first half of 1985.

NATIONAL PRODUCT ACCOUNTS AND KEY ECONOMIC INDICATORS
(Billions of Dollars, SAAR)

	1984				1985		Years		
National Product Accounts	I	II	III	IV	I	II	82	83	84
Gross National Product.....	3,541	3,609	3,684	3,747	3,815	3,881	3,073	3,310	3,645
Consumer Spending.....	2,280	2,328	2,374	2,417	2,462	2,507	1,992	2,158	2,350
Durables.....	310	322	327	331	337	343	244	279	322
Nondurables.....	844	856	872	886	901	915	761	804	865
Services.....	1,126	1,150	1,175	1,199	1,224	1,250	986	1,074	1,163
Nonresidential Fixed Investment.	384	394	405	417	429	441	348	348	400
Structures.....	140	144	148	152	157	161	142	131	146
Equipment.....	244	250	257	265	272	280	206	217	254
Inventory Change.....	62	42	49	47	42	32	-25	-6	50
Residential Investment.....	145	148	150	148	148	149	88	126	148
Federal Government.....	275	300	307	314	325	332	259	275	299
Defense.....	216	220	226	231	239	245	179	200	223
Nondefense.....	59	80	82	83	85	87	79	75	76
State & Local Government.....	436	444	455	465	475	486	391	415	450
Net Exports.....	-45	-52	-61	-66	-69	-71	17	-9	-56
Real GNP (1972 Dollars).....	1,604	1,619	1,635	1,644	1,652	1,659	1,485	1,535	1,625
(% change, annual rate).....	8.3	3.8	3.9	2.2	2.0	1.9	-1.9	3.4	5.9
Implicit Price Deflator.....	2.207	2.229	2.253	2.280	2.310	2.339	2.069	2.156	2.242
(% change, annual rate).....	4.1	4.0	4.4	4.8	5.4	5.1	6.0	4.2	4.0
Key Economic Indicators									
Housing Starts (million units)...	1.950	1.827	1.774	1.681	1.614	1.572	1.056	1.704	1.808
Retail Auto Sales (million units)	10.6	10.6	10.5	10.4	10.4	10.4	8.0	9.2	10.5
Industrial Production (Index, 1967=100).....	159.7	162.0	164.7	165.9	167.2	168.4	138.6	147.6	163.1
Civilian Unemployment Rate.....	7.9	7.6	7.4	7.3	7.4	7.5	9.7	9.6	7.6
Consumer Price Index (% Change, Annual Rate).....	5.0	4.5	5.1	5.3	5.3	5.2	6.2	3.2	4.7
Personal Income (billion $).....	2,925	2,967	3,020	3,072	3,135	3,191	2,579	2,742	2,996
3-Month Treasury Bill Rate (%)...	9.2	9.8	9.6	9.7	10.0	10.2	10.6	8.6	9.6
Corporate Bond Yield (%).....	12.3	12.9	12.8	12.8	12.8	12.7	13.8	12.0	12.7
Personal Income ($ Billions, SAAR).....	2,925	2,967	3,020	3,072	3,135	3,191	2,579	2,742	2,996

SAAR--Seasonally adjusted annual rate.

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McGraw-Hill Economics

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New York, New York 10020

August, 1984

U.S. BUSINESS OUTLOOK SHORT-TERM

The 1984 economy has been a thriller. Capital investment has soared; housing has performed an interest rate high-wire act without taking a bad tumble; in general, economic growth has been breathtaking.

Among the thrills, there have been some spills, like slumping bond and stock markets from early- to mid-1984. But now comes another thrill: A big summer jump in stock prices and sharp plunge in long-term interest rates.

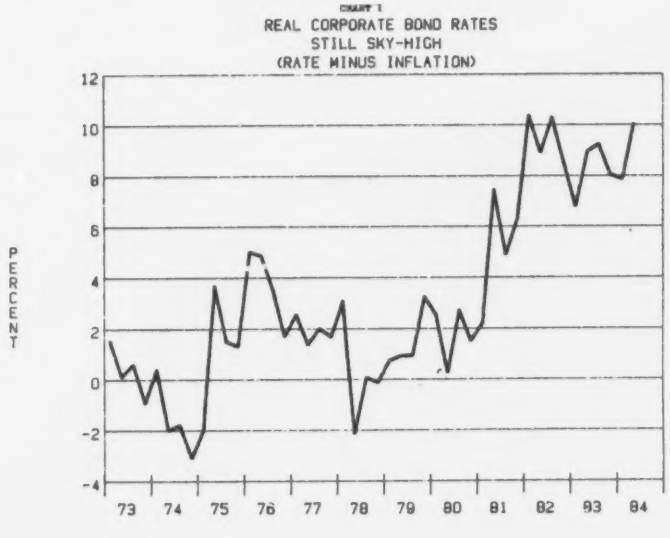
When almost precisely two years ago bonds and stocks skyrocketed, the economy soon recovered from a severe recession and embarked on a highly successful expansion. Is the situation today analagous? Are we set for another sustained period of great growth?

The short answer is "probably not." Note well, for example, that short-term interest rates have not joined in the rate fall; and long-term rates, despite their fall, remain high. Hence interest rates still threaten the economy. Which puts a cloud over 1985.

Interest Rates Should Stay High

Forgetting about 1985 for the moment, the rest of 1984 looks solid. Economic momentum remains strong, which means business will keep spending on plant and equipment and consumers will continue to spend on clothing, appliances, furniture, and services. Spending is expected to slow down from the hectic pace of 1984's first half, especially in autos. But income and profit growth should keep things humming. And the recent drop in long-term rates can only help, if merely as a confidence-booster.

Before getting too excited about the bond market rally, though, consider how high long-term rates still are, and how extremely high they are after adjusting for inflation. (See Chart I.) High market

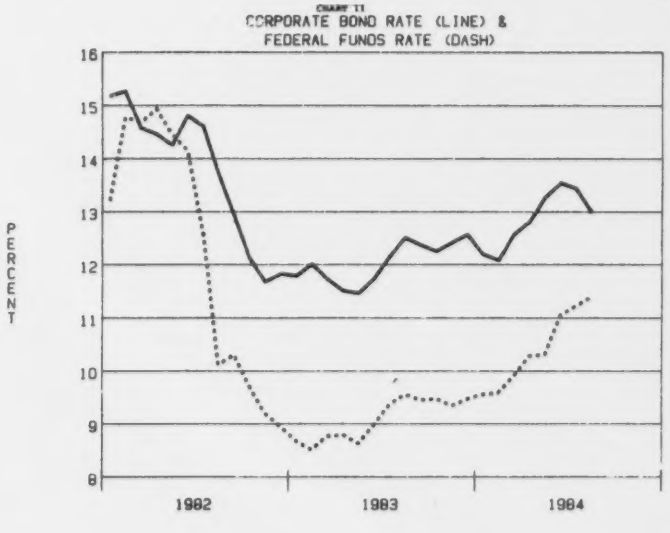


rates coupled with modest inflation poses a tough situation for business: If companies can't raise prices much as a way to earn enough to pay big interest charges, they might opt to curtail spending.

Consumers, meanwhile, are presumably less aware of "real" interest rates, so any rate decline could have more positive impact

with them. Problem is, rates faced by consumers probably won't be much affected. First of all, consumer rates move sluggishly. What's more, short-term rates have not taken the plunge along with long-term rates, as shown in Chart II, where the federal funds rate represent short-term conditions. Thus with banks' cost of funds staying high, they're not likely to lower consumer loan rates much, if at all. Ditto for mortgage rates.

The dive in long rates may reflect, finally, some of the improvement in inflation in the past couple of years. Short-term rates, meanwhile, reflect the old verities of supply and demand, with the demand curve getting bent out of shape by massive government deficits.



In contrast to the recent divergence between short- and long-term rates, in the summer of 1982 both rates fell. Back then, surging money supply coupled with declining inflation and recession-weakened loan demand from the private sector pushed interest rates down. Those forces pushed down harder, that is, than rapidly growing federal budget

deficits pushed up. Today, in contrast, money growth is modest, inflation is staying constant at a fairly low level, and loan demand is strong--extremely strong, in fact, as shown in Chart III.

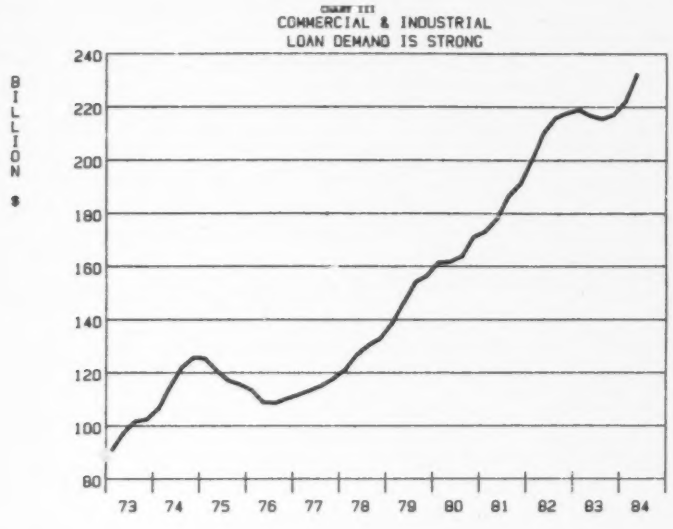


Chart III also shows that in the economic expansion beginning in 1975, it took several years for business loan demand to get back up to previous peak levels. In the 1983-84 recovery, by contrast, loan demand shot back very quickly--a key reason for high and rising short-term interest rates in this current cycle. With business seeking to fund ambitious capital spending programs, borrowing is likely to remain heavy.

One similarity between today and two years ago is that government presence in the credit markets looms large. True, the federal government deficit is now expected to come in a little lower than previously projected; but the size remains enormous--$172 billion in fiscal 1984, as estimated by the Congressional Budget Office. Deficits in the next few years, moreover, are projected to increase, thus keeping constant pressure on the markets.

The strong suit in today's interest rate game is inflation, now running at about a 3% annual rate. That low rate implies long-term rates could come down more than they already have, which is about 1.5 percentage points during the summer. Chart I, for example, suggests that real bond rates are perhaps eight percentage points above the 1970s' norm.

One way for real rates to fall would be for inflation to heat up. But inflation is expected to stay moderate in the next year. The reasons: Modest wage gains, a still-high unemployment rate, sufficient industrial capacity, steady oil prices, and generally weak commodity prices.

Nonetheless, despite inflation's downward pull on long-term interest rates, the bet here is that further dramatic interest rate drops are not in the cards. Financial markets still fear future inflation; and they are still spooked by government deficits, the Third World debt bomb, and shaky domestic banks. Which is perhaps why long-term rates this time around have fallen only half as much as they did in the summer of 1982.

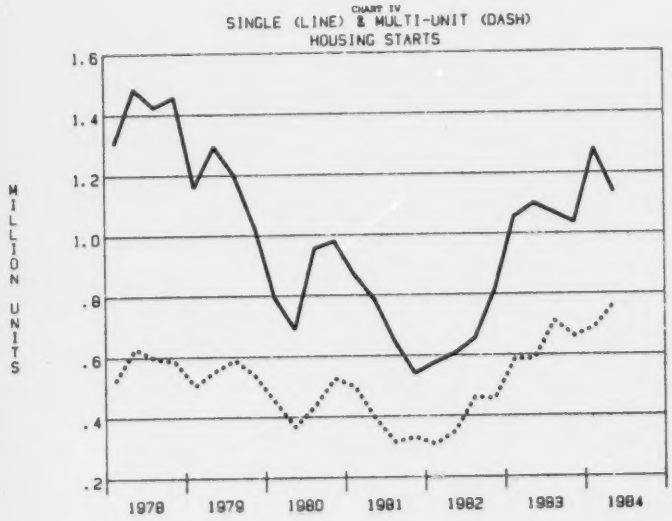
Despite the Boom, High Rates Bite...

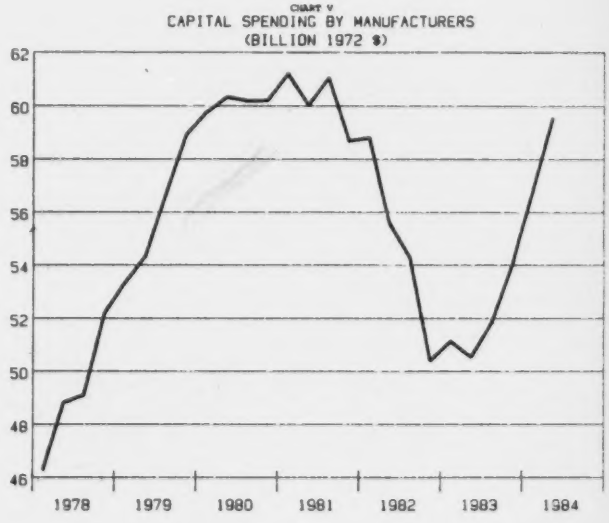
The gist of the above argument is that high interest rates hang like a brooding cloud in the generally sunny skies of the 1984 economy; and they will continue to hang in the less-sunny skies of 1985. One response to this view is, "So what. Let the pessimists brood; high rates notwithstanding, the 1983-84 recovery has been the best in three decades."

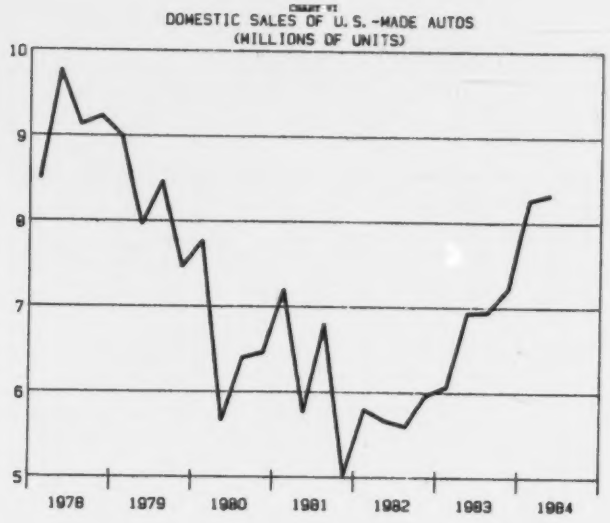
True enough. But then again, the 1981-82 recession was, by some

measures, the worst in three decades. The unemployment rate, for example, hit a record high of 10.7% for the period. If you want to be even harder, you can argue that the U.S. suffered a super-long recession from early 1980 to the end of 1982. So naturally, when the economy finally digs itself out of a deep pit, it initially looks like its making lots of progress because it's come up a long way.

Yet look at Charts IV to VI to see where some key economic measures are now compared to recent years. Quickly: Single-family housing starts are well below their 1978 level, while multi-unit starts have made modest gains; manufacturers' real capital spending, though surging of late, has still not re-attained its peak of several years ago; and U.S. car production, despite the 1983-84 boom, remains far below 1978-79 output levels. After glancing at the charts, it's difficult to pooh-pooh the power of high interest rates to hurt the economy.







...And Housing Will Hurt

Perhaps the market where interest rates pack their biggest wallop is housing, particularly single-family housing. Yet since housing sales and starts zoomed in the past two years, where is the sting of high interest rates?

The answer: Financial wizards--American, not Swiss--came up with and agressively marketed adjustable-rate mortgages (ARMs), which for a limited time shield homebuyers from market interest rates. The assumption is that when an ARM rolls over, interest rates will be down, enabling the mortgagee to pay less than before. At the least, the hope must be that monthly house payments will stay constant.

Trouble is, ARMs written within the past year or so and now rolling over will be sending some homeowners into rate shock. For not only will initial "teaser" rates go out the window; in addition, conventional mortgage rates have been rising in the past half year and are now at their highest since the end of 1982. So some ARM

holders--already straining within their budgets--could face house payment hikes of $100 to $200 per month.

Some of these homeowners may default under the burden of higher mortgage payments, with the result that banks could become more cautious in pushing these still somewhat experimental credit instruments. Even if banks continue to tout ARMs, fewer people may be interested in taking a chance with them. And with mortgage rates expected to stay up in a rarefied atmosphere, the number of people qualifying even for ARMs could fail to grow.

All in all, it seems likely that housing has peaked in this cycle and is headed down the stairs. Recent evidence for this conclusion is the 6.6% drop in housing starts in July. In 1985, the forecast calls for starts of 1.5 million units, compared to an anticipated 1.8 million in 1984.

Although interest rates are expected to have a less powerful effect on other parts of the economy, they will be enough to pull overall economic growth down from more than 7% this year to lesss than 3% in 1985.

Consumer and Capital Spending Look Pretty Good

Less sensitive to interest rate movements in the short run are consumer purchases of autos and business purchases of plant and equipment.

The driving force in auto sales is income. Thus despite car loan rates of nearly 14% in the past two years, U.S. auto companies have enjoyed a burst of sales: From mid-1982 to mid-1984, Americans boosted purchases of U.S.-made cars nearly 50% to 8.3 million units. Total car

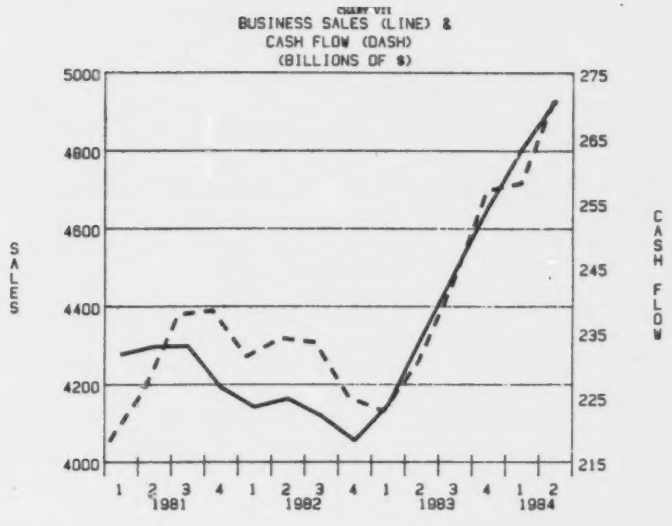
sales, held down by the quotas on Japanese makes, rose 39% to 10.7 million units.

With job growth one of the outstanding successes of the current economic expansion, rising personal incomes should keep pushing people into showrooms. And while production constraints and consumer credit burdens (see table below) will likely keep sales next year from topping sales this year, the auto market is expected to remain strong at least through the first half of 1985.

The Consumer Wobbles, But Still Holds Up

Year/Quarter	Employment (Millions)	Real Disposable Income (Billion 1972 $)	Household Interest Payments as % of Disposable Income	Consumer Sentiment (1966=100)
1983 I	99.2	1073	9.5	75.3
II	100.0	1082	9.7	91.5
III	101.5	1102	9.8	91.6
IV	102.5	1124	10.1	91.5
1984 I	103.7	1148	10.3	99.5
II	105.1	1167	10.7	96.6

For businesses drawing up 1985 capital investment plans, a drop in long-term interest rates might instill some executive confidence. But other things are probably more important--namely, recent and prospective sales and cash flow. Chart VII shows how business sales and corporate cash flow have surged for a year and a half now. That performance suggests continued strength in business capital investment into 1985.



What's more, capital spending typically follows from capital budgets set earlier. Which means that even if the economy cools off as expected, plans to build and to buy equipment will remain in train. Hence after skyrocketing a spectacular 19% in 1984, real capital investment is forecast to continue growing at a solid 8% in 1985. That would make capital spending the major engine of economic growth next year, as it was this year.

Manufacturers, in particular, should continue to make up investment ground lost in the 1981-82 recession. The spring McGraw-Hill survey, for example, showed especially robust spending plans among manufacturers for 1985. In addition, manufacturing production soared in 1984, encouraging firms to plan capacity additions.

Perhaps more important than soaring production, however, was a soaring U.S. dollar, which has made it tougher than usual for U.S. manufacturers to export, and easier than usual for manufactured imports to penetrate the U.S. market. One way for American companies to fight back is to get more efficient by installing the most modern capital equipment available. If the economy slows as expected in 1985, this spur to cutting costs will likely be a more powerful stimulant to capital spending than will capacity expansion.

Summary

The great news this summer has been that rapid economic growth has been accompanied by muffled inflation and falling long-term interest rates. The interest rate fall may finally reflect the huge gap between market rates and inflation. Unfortunately, in the short-term market, rates aren't budging from their lofty levels because loan demand remains strong while money supply growth remains moderate. With government deficits staying huge, loan demand will stay strong and any short-term interest rate decline within the next year will remain limited.

In fact, only a sharp weakening of the economy would pull rates down a lot; but in the near term the economy is expected to grow at a decent rate. At the same time, however, continued high rates will sap the economy's strength, so by the second half of next year a distinct weakening should be evident.

Getting hurt most by high rates will be housing, where demand is currently being propped up by adjustable rate mortgages (ARMs). But with mortgage rates staying high, ARMs that are rolling over may create problems for both borrowers and lenders. Even without ARM problems, high mortgage rates will keep housing demand under wraps.

High rates will affect consumer sending less than housing, because job growth has been very strong; hence growing incomes will fuel continued consumer expenditures. Growing debt burdens, however, could limit car purchases by 1985.

Businesses, meanwhile, may feel somewhat buoyed by the recent drop in long-term rates. More important, plant and equipment outlays in the next half year or more will probably be spurred by the big sales and profits gains of 1983-84. If the economy slows down significantly next year, as forecast, the next crunch in capital spending would come in 1986.

NATIONAL PRODUCT ACCOUNTS AND KEY ECONOMIC INDICATORS
(Billions of Dollars, SAAR)

National Product Accounts	1984 II	1984 III	1984 IV	1985 I	1985 II	1985 III	1985 IV	Years 83	Years 84	Years 85
Gross National Product	3,646	3,728	3,796	3,865	3,913	3,958	4,014	3,305	3,681	3,938
Consumer Spending	2,327	2,373	2,420	2,469	2,507	2,543	2,580	2,156	2,349	2,525
Durables	319	323	332	342	344	344	344	280	321	344
Nondurables	858	871	884	897	909	921	934	802	863	915
Services	1,150	1,179	1,205	1,231	1,255	1,278	1,301	1,074	1,165	1,266
Nonresidential Fixed Investment	421	438	452	464	475	484	492	353	427	479
Structures	152	159	164	169	173	177	181	130	154	175
Equipment	269	279	288	295	302	307	311	223	273	304
Inventory Change	54	58	59	56	50	40	35	-13	61	45
Residential Investment	153	153	149	144	140	139	141	129	150	141
Federal Government	299	305	311	320	325	332	341	270	296	329
Defense	221	226	231	238	242	247	256	201	223	246
Nondefense	78	79	80	82	83	84	85	69	73	84
State & Local Government	447	456	465	474	485	494	504	416	451	489
Net Exports	-58	-58	-63	-66	-73	-78	-82	-8	-58	-75
Real GNP (1972 Dollars)	1,640	1,662	1,676	1,687	1,692	1,693	1,696	1,535	1,647	1,692
(% change, annual rate)	7.5	5.3	3.4	2.8	1.0	0.4	0.7	3.7	7.3	2.7
Implicit Price Deflator	2.223	2.244	2.265	2.291	2.313	2.337	2.367	2.153	2.234	2.327
(% change, annual rate)	3.2	3.7	3.9	4.6	4.0	4.2	5.1	3.8	3.8	4.1
Key Economic Indicators										
Housing Starts (million units)	1.907	1.768	1.634	1.574	1.488	1.489	1.553	1.704	1.819	1.526
Retail Auto Sales (million units)	10.7	10.5	10.8	10.9	10.7	10.6	10.4	9.2	10.6	10.7
Industrial Production (Index, 1967=100)	162.9	165.0	167.0	169.2	169.6	169.5	169.5	147.6	163.7	169.4
Civilian Unemployment Rate	7.5	6.9	6.7	6.6	6.7	7.0	7.2	9.6	7.2	6.9
Consumer Price Index (% Change, Annual Rate)	3.7	3.7	4.4	4.5	4.3	4.6	5.1	3.2	4.3	4.3
Personal Income (billion $)	2,985	3,048	3,102	3,160	3,202	3,254	3,311	2,744	3,014	3,232
3-Month Treasury Bill Rate (%)	9.8	10.2	10.4	10.7	10.8	11.2	11.0	8.6	9.9	10.9
Corporate Bond Yield (%)	13.2	13.7	13.3	13.6	13.6	13.4	13.1	12.0	13.1	13.4
Personal Income ($ Billions, SAAR)	2,985	3,048	3,102	3,160	3,202	3,254	3,311	2,744	3,014	3,232